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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 118

FOOD MACHINERY AND CHEMICAL CORPORATION, a corporation, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinions (Pet. 23-44) of the Court of Claims are reported at 286 F.2d 177. The court's findings of fact are reprinted at Pet. 45-72.

JURISDICTION

The Court of Claims judgment dismissing the taxpayer's petition was entered on December 1, 1960. (Pet. 23, 42.) Taxpayer's motion for rehearing was filed on December 27, 1960, and denied on March 1, 1961. The petition for a writ of certiorari was filed on May 26, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1255(1).

QUESTION PRESENTED

Whether the Court of Claims correctly held that petitioner, an accrual-basis taxpayer, had a fixed right, in its fiscal year 1945, to receive reasonably ascertainable amounts of profit allowances with respect to terminated government war contracts and was therefore obliged to report those amounts as income in that year.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; * * *.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42. [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 111 (1939 Code):

Sec. 29.42-1. [As amended by T.D. 5405, 1944 Cum. Bull. 154] *When Included in Gross Income.*—(a) *In general.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. * * * Except as otherwise stated in this subsection, such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendered on the basis of cash receipts and disbursements. In the case of a termination of a war contract as defined by section 3 of the Contract Settlement Act of 1944 (or the termination of any other Government contract as to which the right to compensation is definitely fixed and the measure thereof is determinable with reasonable accuracy), if the return is rendered on a basis other than cash receipts and disbursements, compensation for the termination shall, unless a different method of reporting is prescribed or approved by the Commissioner, constitute income for the taxable year in which falls the effective date of the termination, except that if any part of the compensation is attributable to cost, expenses, or losses incurred in a subsequent year such part of the compensation shall be returned as income for the subsequent year.

* * * * *

STATEMENT

The taxpayer, a corporation reporting on the accrual basis of accounting and for the fiscal year ending September 30, 1945, manufactured (during World War II) amphibian tanks and spare parts as a prime contractor under fixed-price contracts with the Navy Department. Between November, 1943, and July, 1945, it entered into eleven contracts, all of which were war contracts as defined by the Contract Settlement Act of 1944, c. 358, 58 Stat. 649. (Pet. 24.)

Taxpayer's records indicated the materials purchased for each contract, but items common to several contracts were physically commingled. Its records did not disclose the amount of work in process and only a physical inventory could have determined that amount. The taxpayer made no effort to take such an inventory. (Pet. 25.)

The taxpayer became aware, early in 1945, that its contracts might be terminated, and in late June and early July, 1945, pre-termination conferences were held between the taxpayer's representatives and Captain Rosenstein, the contracting officer in charge of taxpayer's contracts, and other representatives of the Bureau of Ships. The conferees agreed on a profit rate of 4.875 per cent, on the basis of which the taxpayer was to submit its termination claims. (Pet. 25-26.)

On July 19, 1945, the Bureau of Ships submitted a draft pre-termination agreement relating to five contracts. The draft provided, *inter alia*, for a 4.875 per cent rate of profit. The taxpayer did not reply to the draft and no agreement was executed. Between

July 20 and August 30, 1945, all of the taxpayer's eleven contracts were terminated by termination notices under the provisions of the Contract Settlement Act of 1944 and the Joint Termination Regulations; the war ended on August 14, 1945. (Pet. 25-26.)

After receiving the termination notices, taxpayer stopped work and notified suppliers and subcontractors to stop work. Work in process was reviewed with Navy representatives and disposition of some of this material, *e.g.*, scrapping semi-fabricated pieces, was determined and approved by the Navy. As a result of these dispositions of work in process, when taxpayer's inventory was taken it was not possible to distinguish between purchased parts and raw materials on the one hand and work in process on the other. (Pet. 26-27.)

With Captain Rosenstein's permission, taxpayer filed two joint inventory and settlement proposals, each covering four of the terminated contracts. On September 18, 1945, taxpayer's president and the Captain reached an understanding that the 4.875 per cent profit rate remained mutually agreeable and would be claimed by the taxpayer and allowed by the Captain. Captain Rosenstein confirmed this understanding by letter dated September 21, 1945. It was also understood that the profit rate was subject to review by the Government's Settlement Review Board in Washington. (Pet. 27.)

On or about November 26, 1945, Captain Rosenstein orally granted taxpayer's request to submit one settlement proposal covering all of its terminated contracts, apportioning charges *pro rata*, and on November 27

the taxpayer filed its first settlement proposal. The Supervisor of Shipbuilding confirmed the authorization by letter dated December 7. The claim stated a total inventory of metals, purchased parts, finished components, and work in process of $18,618,592.43. At the 4.875 per cent rate of profit, taxpayer claimed a profit of $907,656.38. (Pet. 27-28.)

The claim was received by the Bureau of Ships' Contract Termination Section in Washington on or about January 3, 1946, with a report dated December 14, 1945, from the Supervisor of Shipbuilding. The report stated that Navy personnel had examined the inventories and checked prices and that materials were found in good condition and properly allocable to the terminated contracts. The report referred to such questionable items in the claim as taxpayer's failure to deduct cash discounts from costs and indicated that no adjustment was required because taxpayer had waived other items of cost. The report further noted that the profit rate requested was based on the rate agreed on at the September 18, 1945, meeting and that purchased parts constituted a larger percentage of total inventories than appeared to have been anticipated during negotiations on the profit rate. (Pet. 28.)

On January 8, 1946, at a meeting with the Navy representatives, the taxpayer was asked to apply for partial payment of its claim. Although taxpayer refused to apply, partial payment of $18,500,000 was tendered to and accepted by taxpayer's president on January 10. This represented about 95 per cent of taxpayer's total claim; the payment did not represent any allowance for profit or disposal credits and was

less than the sum claimed for inventories. At the January 8 meeting, taxpayer was also asked to supply data explaining the variation between the estimated amount of work in process and the amount reflected in taxpayer's claim. Taxpaper made an explanation by letter in February. (Pet. 28-29.)

On March 26, 1946, Captain Rosenstein submitted to the Settlement Review Board written proposals for settling taxpayer's claim. Except for freight charges of $21,222, he recommended that taxpayer's claim be accepted as submitted; taxpayer's claim for profit was reduced about $1,000 by that adjustment, *i.e.*, to $906,621.81. The Board approved the settlement on March 27, 1946, and the Chief of the Bureau of Ships approved the Board's action. After execution of documents relating to the termination claim, payments of the amounts due on the claim (minus the January 10, 1946, payment of $18,500,000) were made on June 12 and 13, 1946. Final disposition of other claims filed on behalf of subcontractors was made on January 9, 1947, by execution of final contracts and final payment to taxpayer. In the final settlement, the profit of $906,621.81 allowed on taxpayer's first claim was approved. (Pet. 29-30.)

The $906,621.81 allowed taxpayer as profit on its terminated contracts was included in taxpayer's return for its fiscal year ending September 30, 1945. Taxpayer filed a timely claim for refund of income and excess profits taxes of $652,767.67 on the ground that its profit allowance was not properly includible in income for fiscal 1945. The Commissioner disallowed the claim and the taxpayer timely filed a petition for

refund of the taxes in the Court of Claims.[1] (Pet. 30-31.)

The Court of Claims (one judge dissenting) held that under the Contract Settlement Act of 1944 the taxpayer had a right, upon termination of its contracts, to compensation for its material and labor expenditures and to a profit based on those costs. It found that the cost and inventory amounts to which taxpayer was entitled were reasonably ascertainable from taxpayer's books and that negotiations between the parties had reached a stage of sufficient agreement by the end of fiscal 1945 for the amount of its profit allowance to be considered reasonably ascertainable at that time. Accordingly, the court concluded that the taxpayer's profit allowance accrued as income during its taxable year ended September 30, 1945, and ordered taxpayer's petition dismissed. (Pet. 23-44.)

ARGUMENT

In holding that taxpayer's profit allowance was properly accruable as income of its fiscal year 1945, the Court of Claims followed accepted rules of accrual-basis tax accounting. There is no conflict and no occasion for further review.

1. Section 41 of the Internal Revenue Code of 1939, *supra*, p. 2, provides that net income shall be computed upon the basis of the taxpayer's annual accounting

[1] The inclusion of the $906,621.81 in income of fiscal 1945 is resisted by the taxpayer because 1946 income was not subject to the excess profits tax, and also because the amount of income in 1946 directly affects the excess profits credit available under 1939 Code Section 435(c) and (b), as amended, and thus affects its excess profits tax liability for 1950-1954.

period in accordance with the method of accounting regularly employed in keeping its books. Under the accrual basis of accounting, income is accruable in the year in which the taxpayer has a fixed right to receive a reasonably ascertainable amount. *Spring City Co.* v. *Commissioner*, 292 U.S. 182, 184-185; *Security Mills Co.* v. *Commissioner*, 321 U.S. 281, 286-287; *Commissioner* v. *Bamari Textile Co.*, 142 F. 2d 897 (C.A. 2d); *H. Liebes & Co.* v. *Commissioner*, 90 F. 2d 932 (C.A. 9th).

The taxpayer entered into war contracts which were terminated under the provisions of the Contract Settlement Act of 1944, c. 358, 58 Stat. 649. (Pet. 73-78.) Under Section 6 of that Act, it had a right to compensation for costs incurred under the terminated portions of the contracts for materials and labor as well as an allowance for profit on those costs. This right to compensation became fixed when the contracts were terminated by the Government.[2]

In deciding that the amount of income to which the taxpayer was entitled under the Settlement Act was reasonably ascertainable in taxpayer's fiscal year 1945, the court applied (Pet. 33-36, 39) the principles enunciated in *Continental Tie & L. Co.* v. *United States*, 286

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[2] The taxpayer in its briefs below recognized that it had a *right* to compensation when the contracts were terminated, although it strenuously argued that the Settlement Act neither fixed the *amount* of its profit allowance nor provided a formula for determining that amount. The Court of Claims noted taxpayer's concession of this point and assumed that taxpayer's right to compensation was fixed under the Settlement Act in taxable year 1945. (Pet. 31, 33.) Taxpayer now seeks to raise a new issue in this Court by arguing that (Pet. 16) its "right to receive a profit allowance on its terminated contracts was not fixed by a binding final settlement until 1946".

U.S. 290. In that case, it was held that a railroad's right to an award under the Transportation Act of 1920 was fixed by the Act and that the Interstate Commerce Commission's function of ascertaining the amount of the award was ministerial. Furthermore, since all of the information on which the award was to be computed was contained in taxpayer's books and accounts, the Court held that the amount of the award could be ascertained within reasonable limits, even though the statute only formulated general principles and did not cover in detail the treatment of certain accounts with respect to which there might be a difference of opinion. It accordingly concluded that the amount of the award accrued in 1920, when the Act was passed, rather than in the year of payment.

The Court of Claims similarly found on the record before it that the inventory and cost amounts were ascertainable within reasonable limits before the close of taxpayer's fiscal year 1945. (Pet. 36.) It noted that the taxpayer's books and records contained the information from which the amount of inventory and other costs could be reasonably determined and that the question concerning the inventory accounts did not bar such a determination. In fact, the taxpayer, shortly after the close of its taxable year, filed its first settlement proposal covering inventory and other costs of some $18,618,592, which was accepted as submitted except for an adjustment of only $21,222. (Pet. 28-30.) The acceptance of the proposal squarely supports the conclusion that the inventory and other costs could be reasonably estimated.

Since under the Settlement Act the profit allowance is computed by taking a percentage of the inventory and costs, accrual of the allowance in 1945 depends further on whether the profit rate was reasonably settled in that year. The court below noted (Pet. 36-37) that the rate of profit was not an amount to be found in taxpayer's books and accounts and that to this extent the case was different from *Continental Tie*. However, in keeping with the principle that income accrues when the right to receive it is fixed and the amount can be reasonably estimated (*Spring City Co. v. Commissioner*, 292 U.S. 182), the court decided that the rate of profit had become sufficiently settled by negotiation prior to September 30, 1945, to permit the profit allowance to be ascertained within reasonable limits. (Pet. 37-40.) On this point, the court found that the profit rate had been tentatively agreed upon by the Navy and the taxpayer by July, 1945, and that the rate was confirmed prior to September 30, 1945, and not later disputed or reconsidered. (Pet. 38-39.) The court correctly

[illegible] (Contrary to taxpayer's assertion (Pet. 12-15) [illegible] concluded that the category [illegible] could be [illegible] taxpayer [illegible] ascertainable before the close of the 1945 [illegible] year, the court below applied an objective rather than a subjective [illegible] not only in *Continental Tie* but also in the [illegible] Act (Pet. 14-16). See also Section 29.42-1 of Treasury Regulations 111, *supra*, p. 3; Rev. Rul. 55-205, 1955-1 Cum. Bull. 325; Mim. 5897, 1945 Cum. Bull. 131. After correctly analyzing the evidence (Pet. 23-39), it concluded that (Pet. 40) under the facts and circumstances of this case negotiations between the parties had reached a stage of sufficient agreement by the end of April 1945 for the amount of plaintiff's profit allowance to be considered to be reasonably ascertainable at that time. It also noted (Pet. 37-38) that there was "no visible discord" between the parties as to the method of ascertaining the amount allowable.

held that the lack of a formal approval of the settlement agreement by the Settlement Review Board was not conclusive, in the circumstances, on the question whether the rate was reasonably ascertainable.[4]

2. The taxpayer advances three contentions in support of its petition.

The first (Pet. 12-15) is that the Court of Claims applied a "subjective expectancy-of-settlement test" in holding that the income accrued in fiscal 1945. Taxpayer's argument is apparently based on its erroneous statement (Pet. 11, 15) that the court deemed the reasoning of *Continental Tie* inapplicable to the case at bar and thus turned to what the taxpayer describes as a subjective test. Although the court observed that the instant case was factually different from *Continental Tie* because here it was necessary to go outside of the taxpayer's books and records to find whether the amount to be accrued was reasonably ascertainable, it applied the principles there laid down to the facts of this case. Thus, in order to determine whether the amount was reasonably ascertainable in 1945, it examined the evidence of agreement between the parties, such as conversations and communications passing between them, and the absence of discussions relating to a new profit rate. (Pet. 38-40.) It did not examine or rely on evidence of uncommunicated thoughts and

[4] Judge Whitaker's dissent (Pet. 42-44) was based on the ground that the profit rate was not determined until a binding settlement had been reached. The dissent, however, failed to recognize that the standard for accruing income is whether the amount of income can be reasonably ascertained—not whether the amount is fixed and known exactly.

intents of either party, the usual indicia of a subjective test. See *Commissioner* v. *Fifth Avenue Coach Lines, Inc.*, 281 F.2d 556 (C.A. 2d), reversing in part 31 T.C. 1080; *Hotchkiss* v. *National City Bank of New York*, 200 Fed. 287, 293 (S.D. N.Y.). Its finding that the amount of profit allowance was reasonably ascertainable was based on the "objective" circumstances shown by the record before it.

The second ground urged (Pet. 15-18) is that taxpayer had no fixed right to a profit allowance as a result of the termination of its war contracts in 1945. As pointed out above (note 2, p. 9), the taxpayer conceded below that it had a fixed right to a profit allowance when the contracts were terminated, and the issue litigated was whether the amount of income was reasonably ascertainable. The taxpayer cannot now be heard to argue that it had no such right in 1945.

The third reason for review urged by taxpayer (Pet. 18-21) is that the question of accrual of income resulting from termination of Government contracts involves substantial revenue and many taxpayers. However, the issue is of little, if any, importance for the future, since it relates to accruability of compensation for terminated Second World War contracts under the provisions of the Contract Settlement Act of 1944. Moreover, the decision turns on the application of settled accrual accounting principles to the facts of a particular case.

[illegible] The taxpayer asserts (Pet. 19) that the same question presented in this case continues to arise in the case of "[illegible] military contracts terminated for the convenience of the Government". However, it refers to no other pending case [illegible] of note.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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